Moody's Investors Service

Global Credit Research
New Issue
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New Issue: Hawaii (State of)

MOODY'S ASSIGNS Aa3 RATING TO STATE OF HAWAII GO BONDS

State Credit Outlook Remains Stable

State
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Moody's Rating

ISSUE	RATING
General Obligation Bonds of 2004, Series DD	Aa3

Sale Amount	$225,000,000
Expected Sale Date	04/28/04
Rating Description	General Obligation Bonds

Opinion

NEW YORK, Apr 26, 2004 -- Moody's has assigned a rating of Aa3 and a stable outlook to the State of Hawaii's general obligation bonds, in conjunction with the upcoming 2004, Series DD bond sale. The Series DA bonds will be used to finance or to reimburse the state for certain expenditures for public purposes for which appropriations have been made. These include the Hawaiian Home Lands Settlement and various capital projects to improve elementary and secondary schools, community colleges, universities, public parks and libraries.

The Aa3 rating reflects the state's historical fiscal conservatism, continued diversification of its economy, and the financial volatility caused by its tourism-based economy. The state's credit strengths are tempered by the tourism industry's reliance on the Japanese and California markets, and its high debt burden.

CONSERVATIVE BUDGET CONTROLS POSITION STATE WELL TO MANAGE ECONOMIC DOWNTURNS

Pursuant to the state constitution, the state legislature is required to establish a General Fund expenditure ceiling that limits the annual rate of expenditure growth to the rate of growth of the economy. State appropriation levels from the General Fund may not exceed the expenditure ceiling without a two-thirds vote of both houses of the legislature. The expenditure ceiling is determined by adjusting the prior year expenditure ceiling by the estimated growth in the state economy. This growth factor is determined by averaging the annual percentage change in total state personal income for the prior three years. Appropriations for the last six fiscal years did not exceed the expenditure ceiling, and appropriations for the current biennium (fiscal years 2004 and 2005) are also below the expenditure ceiling. This expenditure limitation, combined with conservative forecasting and periodic updating by the state's Council on Revenues, enables the state to mitigate fiscal stress during the business cycle.

DESPITE POSITIVE REVENUE GROWTH, FUND BALANCE DRAWDOWNS CONTINUE TO BE NEEDED TO COVER OPERATING DEFICITS

Fiscal 2003 audited financial data indicates that General Fund tax revenue collections posted gains of 4.1% over prior year actuals, rebounding from the 4.0% decline in collections posted in fiscal 2002. In 2002, the state was forced to tap its available fund balances to address a $215 million budgetary shortfall as a result of the precipitous decline in revenue collections. The decline was due in large part to the negative impact of the September 11th attacks had on Hawaiian tourism, the state's primary economic driver.

The positive results in fiscal 2003 reflected the strong rebound in general excise and use tax receipts, resulting from the steady improvement in visitor arrivals since the terrorist attacks of September 11, 2001. The positive revenue performance also reflects the continued strength of the construction industry, as both the commercial and residential construction markets remain strong in this low interest rate environment. But despite such positive revenue growth in 2003, the state was forced to tap its fund balances for a second straight year, albeit by a modest $16.8 million, to address its budgetary shortfall.

The state Council on Revenues' most recent forecast (March 2004) assumes tax revenue growth of 5.2% in the current year. Actual collections through the first eight months of the fiscal year have slightly outpaced this estimate. Despite continued positive economic and revenue results, the state anticipates it will post an operating deficit for the third straight year, necessitating additional fund balance draw-downs to meet its spending commitments.

COUNCIL ON REVENUES FORECASTS HEALTHY REVENUE GROWTH THROUGH 2006; DESPITE GROWTH, ADD'L FUND BALANCE DRAW-DOWNS EXPECTED

The State Constitution requires the Council on Revenues to prepare revenue estimates which serve as the basis for the governor's budget preparation and the legislature's appropriation of funds and enactment of revenue measures. The council reports its estimates and revisions each June 1, September 10, January 10, and March 15. The council also revises its estimates when it determines that such revisions are necessary or upon request of the governor or the legislature.

The latest council forecast released last month anticipates revenue growth prior to adjustments of at least 5% each year through 2006. In December, the council lowered its revenue growth assumption for the current year to 5.2% from 6.2%, but raised its estimate for the second year of the biennium (2005) a full percentage point to 7.9%. The positive revenue outlook reflects the continued strength of the Hawaiian economy, particularly the construction sector which anticipates output growth in excess of 10% in 2005, and personal income growth - adjusted for inflation - will be 3% or higher in each of the next three calendar years including the current year. Through the first nine months of fiscal 2004, General Fund tax revenues are outpacing the council's estimate for the current year, with collections exceeding prior year actuals for the same period by 5.5%. The healthy gains have been driven, in part, by personal and corporate income gains and reduced corporate income refunds.

When incorporated into the state's General Fund Financial Plan, the ending fund balance for fiscal 2004 is $84.6 million, a decrease of $32.6 million from the prior year. The decrease reflects the projected operating deficit forecasted due to the council's reduced tax revenue estimate. The projected ending fund balance does not include the balance of the Emergency & Budget Reserve Fund ($54.3 million). Combined, these balances represent a moderate 3.6% of total General Fund appropriations.

Despite the healthy tax revenue growth anticipated through 2006, the state is still expected to post operating deficits each year, thus requiring additional fund balance draw-downs. While the state's balances will be reduced over the next two years, the state does not anticipate the need to draw on its Emergency & Budget Reserve Fund. The estimated EBRF fund balance at the end of fiscal 2006 is $73.5 million, a modest 1% of total projected appropriations.

ECONOMY CONTINUES TO OUTPACE NATION; TOURISM INDUSTRY STABLE THROUGH 2003 DESPITE CONTINUED WEAKNESS OF JAPANESE MARKET

The state posted a 2% gain in total non-farm employment in 2003, the fourth consecutive year of positive jobs growth in Hawaii as reported by the Bureau of Labor Statistics. The state's performance last year easily outpaced that of the nation which realized net job losses for the second consecutive year. The national economic performance continues to be tempered by job losses in the manufacturing sector, a sector that represents less than 3% of total employment in Hawaii. It should be noted that unlike previous years, the state's primary source of jobs growth was not the government sector. Private sector employment posted 2.2% growth in 2003, realizing employment gains in several industry sectors, particularly services and construction. As previously mentioned, the construction sector remains strong due to the current low interest rate environment. The services sector growth reflects the increasing diversity of the state's employment base beyond the tourism industry, with positive gains posted in educational and health services, and professional and business services.

Overall visitor arrivals continue to be tempered by weakness in international arrivals, reflecting the absence of a meaningful Japanese economic recovery, one of its principle tourism markets. Domestic travel continues to remain strong, posting a 3% growth in 2003 over the prior year. Despite a modest (-0.7%) decline in total visitor arrivals in 2003, the state's tourism industry realized positive gains in various other key industry indicators including visitor days, length of stay, and hotel room and occupancy rates. Visitor data through the first two months of the current year have been positive, with domestic arrivals for the month of February surpassing all records for the month. The strength of domestic travel offset continued declines in international arrivals, which has posted a 6.1% decline in arrivals year-to-date. The Japanese visitor continues to spend the most of all visitors to Hawaii, reflecting the current strength of the yen. But even with the overall decline in visitor days in 2003, the leisure and hospitality industry continues to post job growth and has recently reached its pre-September 11th employment levels.

The state economy should benefit from military expansion plans over the next four to six years, including basing the Stryker Brigade Combat Team in Hawaii, and the privatization of military housing. In addition, the construction industry is expected to remain strong in the near term given the growth in private building permits. The state is expected to continue to outpace the nation in terms of employment growth over the near term.

"RAINY DAY" FUND BALANCE FUNDED WITH TOBACCO SETTLEMENT PAYMENTS

As part of the $206 billion Tobacco Settlement master agreement between the major tobacco companies and 46 states and 5 US territories, the state of Hawaii is expected to receive $1.18 billion over the next 25 years. The annual payments to the state will range from $38 million to $50 million.

During the 1999 legislative session, the state legislature approved a bill stipulating how these settlement proceeds would be allocated. Pursuant to the provisions of the bill which was signed into law on June 7, 1999, 40% of the annual payments received will be deposited into a newly-created Emergency Budget and Reserve Fund (EBR). The law also stipulates that appropriations from the fund can only be made during times of emergency, economic downturn or unforeseen reductions in revenues.

The state has since revised this allocation method by reducing the percentage of the payment to be pledged to the EBR. Beginning in fiscal 2004, only 24.5% of the annual settlement payments will be pledged to the fund.

DEBT BURDEN REMAINS AMONG THE HIGHEST IN NATION

The state has historically been one of the nation's most heavily-indebted states, both in terms of net tax-supported debt as a percentage of revenue, and debt per capita. Based on our 2004 State Debt Medians Report, only two states rank higher than Hawaii based on debt per capita, in part because the state provides capital funding for many functions performed at the local level in other states, such as capital financing for schools. For debt as a percentage of personal income, the state's 10.4% ratio is more than 4 times the 50-state median. This high debt burden places significant strain on the states operating budget, as total general obligation bond debt service as a percentage of the budget exceeds 10%.

Outlook

The outlook for the state is stable. Growth for the state's tourism-dependent economy is expected to continue, though such growth could stall should the economies of either of its two major markets (US and Japan, but particularly the US) fails to produce a sustainable recovery. Military investment in the state should generate economic growth over the next several years, and its presence in Hawaii should benefit from the nation's heightened state of alert. While the state is expected to continue to draw down fund balances to meet its spending commitments, Moody's expects the state to make the necessary budgetary adjustments to maintain fiscal stability.

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